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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 640

BANGOR AND AROOSTOOK RAILROAD COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (R. 37-47) is reported at 193 F. 2d 827. The findings of fact and opinion of the Tax Court (R. 11-23) are reported at 16 T.C. 578.

JURISDICTION

The judgment of the Court of Appeals was entered on December 31, 1951. (R. 47.) The peti-

tion for a writ of certiorari was filed on March 8, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

In 1942, taxpayer purchased its bonds in the open market for less than their face value, realizing a profit in the amount of the difference. Pursuant to the option provided in Code Sections 22(b)(9) and 113(b)(3), the bond profit, however, was excluded from taxpayer's income for income tax purposes and was applied, instead, in the reduction of the basis of taxpayer's property. The question is whether, in computing the excess profits tax credit, the bond profit was includible under Section 718(a)(4) of the Code in taxpayer's equity invested capital as part of its accumulated earnings and profits as of the beginning of 1943.

STATUTE AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*, pp. 9-19.

STATEMENT

The facts were found by the Tax Court as stipulated. (R. 12-14.) The facts so found may be summarized as follows:

Taxpayer, a Maine corporation, kept its books and prepared both income and excess profits tax returns on the accrual and calendar year basis. (R. 12.)

In 1942, it purchased in the open market certain of its bonds aggregating in value $634,000, for

which it paid $497,553.30. The difference, $136,446.70 (hereinafter referred to as the "bond profit"), was recorded in the profit and loss accounts of taxpayer's books maintained in accordance with a system of accounts prescribed by the Interstate Commerce Commission. (R. 12.)

Taxpayer did not report this profit in either its income or excess profits tax returns for 1942. Instead, it filed a Treasury Department form by which it elected to exclude the bond profit from gross income pursuant to Code Section 22(b)(9), and consented to have the basis of its property adjusted in accordance with the Commissioner's Regulations under Section 113(b)(3). Notwithstanding this consent, taxpayer did not reduce the basis of any property either on its books or on its tax returns. As a result, in its income tax return for 1942, taxpayer claimed deductions for depreciation, cost of property retired and replaced, losses on retirement and losses on equipment destroyed[1] computed on the unreduced basis. (R. 13.)

In computing its excess profits credit on the invested capital method it elected, taxpayer included in accumulated earnings and profits (which is, in turn, includible in equity invested capital) the bond profit of $136,446.70. (R. 13.)

In auditing taxpayer's 1942 income tax return, the Commissioner reduced the basis of taxpayer's

[1] For convenience, these items hereinafter will be collectively referred to as depreciation.

depreciable property pursuant to Section 113(b)(3) and the consent filed by the taxpayer. The reduction in basis required a reduction of $1,736.69 in the amounts of the above-described deductions taken in 1942 for depreciation. This and other adjustments not here material are conceded by taxpayer to have been correct. (R. 13-14.)

The total amount disallowed in reduction of taxpayer's 1942 net income ($3,396.32) was added by the Commissioner to taxpayer's accumulated earnings and profits as of the beginning of 1943. At the same time, however, those earnings and profits were decreased by the Commissioner in the amount of the bond profit of $136,446.70. On the basis of the resulting reduction in the excess profits credit, the Commissioner asserted a deficiency in taxpayer's excess profits tax for 1943. (R. 14.) The Tax Court, in a reviewed decision from which no judge dissented, approved the Commissioner's action. (R. 23.) The Court of Appeals affirmed. (R. 47.)

ARGUMENT

It was the unanimous holding of both courts below that the income realized when taxpayer purchased its own bonds at less than face value (see *United States* v. *Kirby Lumber Co.*, 284 U.S. 1; *Helvering* v. *Amer. Chicle Co.*, 291 U.S. 426; *Commissioner* v. *Jacobson*, 336 U.S. 28), but which was not recognized for tax purposes as a result of the option conferred by Sections 22(b)(9) and 113(b)(3), Internal Revenue Code (Appendix, *infra*, pp.

9, 10-11) (see *Commissioner* v. *Jacobson, supra,* pp. 45-46), did not become part of taxpayer's earnings and profits as of the beginning of the next taxable year, was consequently not includible under Section 718(a)(4) of the Code (Appendix, *infra,* p. 14) in its equity invested capital and, accordingly, was not a part of its excess profits tax credit. This holding is unquestionably correct, and, while one of first impression, is directly supported by controlling analogous decisions of this Court. *Commissioner* v. *Wheeler,* 324 U.S. 542; *Commissioner* v. *South Texas Co.,* 333 U.S. 496. Accordingly, there is no reason for further review here.

It is plain from the provisions of Section 22(b)(9) and the correlative provisions of Sections 113(b)(3), that the realized bond profit was not exempt from tax, but that taxation was merely postponed. See Treasury Regulations 111, Sections 29.22(b)(9)-1 and 29.113(b)(3)-1 (Appendix, *infra,* pp. 14-16); H. Rep. No. 855, 76th Cong., 1st Sess., p. 24 (1939-2 Cum. Bull. 504, 522-523); *Commissioner* v. *Jacobson, supra.* As the Court of Appeals correctly noted (R. 45), Section 22(b)(9) is comparable to the Section 112 delayed recognition situation. Both "stem from a common legislative conviction that it is fairer not to impose the income tax forthwith * * *, but to postpone the recognition of the gain, and the incidence of the tax, until the occurrence of an economically more significant event." That being so, Section

115(l) (Appendix, *infra,* pp. 11-13), Section 29.115-3 of Treasury Regulations 111 (Appendix, *infra,* pp. 16-19), and this Court's decisions in *Commissioner* v. *Wheeler, supra,* and *Commissioner* v. *South Texas Co., supra,* are controlling.

In the *Wheeler* case this Court held valid and controlling Section 29.115-3, Treasury Regulations 111, and its counterpart in previous Regulations. The Regulations provided that "Gains and losses within the purview of section 112 * * * are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section." The regulation, after its first appearance as Article 115-3, Regulations 94, promulgated under the Revenue Act of 1936, was expressly approved by Congress when, by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, Section 115(l) was added to the Code. Although the bond profit here was not technically a gain from the sale of property, the rule expressed in Section 115(l), the Regulations, and *Commissioner* v. *Wheeler, supra,* based as it is on the theory that earnings and profits are augmented when gain is recognized, is equally applicable here. This conclusion is underlined by the Report of the Committee on Ways and Means (H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41-43 (1940-2 Cum. Bull. 496, 526-527)), explaining Section 115(l), in which it was stated that while the section prescribes rules for certain cases, the section contemplates that

"*consistently with these rules* the computation shall be made conformably to the best accounting practice." (Italics supplied.)

Actually, Section 115(l) by its terms directs the result reached below. Since under Section 113(b)(3), the basis of the assets deemed to be represented by the bonds under the Regulations was reduced by the amount of the bond profit, it follows that on the disposition of those assets the gain recognized at that time will be increased (or the loss decreased) by the amount of the bond profit. Because, as noted, *supra*, Section 115(l) expressly provides that earnings and profits will be affected only at the time of a recognized gain or loss on the sale or other disposition of property, it follows that earnings and profits cannot be adjusted, as taxpayer contends, at the time the bonds were purchased. Taxpayer's argument to the contrary (Pet. 12-14) is based on its assumption that a different treatment from that provided by Section 115(l) can, because taxpayer consents, be afforded to the gain or loss from the sale of the assets. This contention is not only contrary to the statute but, as the Court of Appeals correctly noted (R. 43, 46-47), is untenable in light of this Court's holding in *Commissioner* v. *South Texas Co., supra.*

Taxpayer's reasons for granting the writ (Pet. 4) are without merit. Numbers one and three go to the merits of the question decided below and that question, as already stated, was correctly de-

cided. In any event, it is undisputed that the question is one of first impression. Taxpayer's assertion (Pet. 4) that the decisions below are "in conflict with applicable decisions of this Court and at variance with principles enunciated therein" is baseless. The statement apparently has reference to *Commissioner* v. *Jacobson, supra* (Pet. 6-8); *Commissioner* v. *Wheeler, supra* (Pet. 7, 11); *Commissioner* v. *South Texas Co., supra* (Pet. 11-12); and *Schwegmann Bros.* v. *Calvert Corp.*, 341 U.S. 384. But the first three decisions directly support the decision below for the reasons outlined *supra*, and as explained in more detail in the comprehensive opinions of both the Tax Court and of the Court of Appeals. The *Schwegmann Bros.* decision is not even remotely applicable to the question presented by the petition.

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition should be denied.

Respectfully submitted,

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APRIL, 1952.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * *

(9) [Added by Section 215(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862; amended by Section 114(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Income from Discharge of Indebtedness.*—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113(b)(3) then in effect. * * *

* * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * *

(3) [Added by Section 215(b) of the Revenue Act of 1939 *supra,*] *Discharge of Indebtedness.*—Where in the case of a corporation any amount is excluded from gross income under section 22(b)(9) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 22(b)(9)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Commissioner with the approval of the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in

section 22(b)(9). The reduction shall be made as of the first day of the taxable year in which the discharge occurred except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

(26 U.S.C. 1946 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * *

(26 U.S.C. 1946 ed., Sec. 114.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * *

(l) [Added by Section 501(a) of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, and amended by Section 146(a) of the Revenue Act of 1942, *supra*] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect

to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * *

(26 U.S.C. 1946 ed., Sec. 115.)

SEC. 718 [Added by Section 201 of the Second Revenue Act of 1940, *supra*]. EQUITY INVESTED CAPITAL.[2]

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * *

(26 U.S.C. 1946 ed., Sec. 718.)

SEC. 728 [Added by Section 201 of the Second Revenue Act of 1940, *supra*]. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U.S.C. 1946 ed., Sec. 728.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.22(b)(9)-1. *Income from Discharge of Indebtedness.*—Section 22(b)(9) provides,

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[2] Chapter 2—Subchapter E (World War II excess Profits Tax) was repealed by Section 122(a), Revenue Act of 1945, c. 453, 59 Stat. 556, for years beginning after December 31, 1945.

with respect to taxable years beginning after December 31, 1941, and before January 1, 1946, a method whereby a corporation may elect to have excluded from its gross income the amount of income attributable to a discharge, within the taxable year, of its indebtedness or of indebtedness for which it is liable as, for example, in the case of a debt arising from an assumption of liability of another corporation. To be entitled to the benefits of the provisions of section 22(b)(9) for such years a corporation must file with its return for the taxable year a consent to the provisions of the regulations, in effect at the time of the filing of the return, prescribed under section 113(b)(3) (see sections 29.113(b)(3)-1 and 29.113(b)(3)-2, relating to adjustment of basis).

* * *

Sec. 29.113(b)(3)-1 [Amended by T.D. 5402, 1944 Cum. Bull. 229, 240]. *Adjusted Basis: Discharge of Corporate Indebtedness: General Rule.*—In addition to the adjustments provided in section 113(b)(1) and section 29.113(b)(1)-1 which are required to be made with respect to the cost or other basis of property, and except as otherwise provided in section 113(a)(21) or (22), or 113(b)(4), a further adjustment shall be made in any case in which there shall have been an exclusion from gross income under section 22(b)(9) on account of the discharge of in-

debtedness of a corporation during the taxable year. Such further adjustment shall, except as otherwise provided in section 29.113(b)(3)-2, be made in the following manner and order:

* * *

Sec. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion or depreciation is a factor in the determination of income, the only depletion or depreciation deductions to be considered in the computation of the total earnings and profits are those based on cost or other basis without regard to March 1, 1913, value. In computing the earnings and profits for any period beginning after February 28, 1913, the only depletion or depreciation deductions to be considered are those based on (1) cost or other basis, if the depletable or depreciable asset was acquired subsequent to February

28, 1913, or (2) adjusted cost of March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery or percentage depletion under all Revenue Acts for mines and oil and gas wells is not to be taken into consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation. The provisions of this paragraph may be illustrated by the following example:

Example. Oil producing property which A had acquired in 1936 at a cost of $28,000 was transferred to the Y Corporation in December 1938, in exchange for all of its capital stock. The fair market value of the stock and of the property as of the date of the transfer was $247,000. The Y Corporation, after four years' operations, effected in 1942 a cash distribution to A in the amount of $165,000. In determining the extent to which the earnings and profits of the Y Corporation available for dividend distributions have been increased as the result of production and sale of oil, the depletion to be taken into account is to be computed upon the basis of $28,000 established in the nontaxable exchange

in 1938 regardless of the fair market value of the property or of the stock issued in exchange therefor.

* * *

Treasury Regulations 112, promulgated under the Internal Revenue Code:

Sec. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. * * *

* * *

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